Supreme Court, U. S.
FILED
NOV 29 1979
JR., CLERK

In The

Supreme Court of the United States

October Term, 1979

No. 79-66

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR PETITIONER

BARRY M. FALLICK
KENNETH J. PLATZER
Attorneys for Petitioner
230 Park Avenue
New York, New York 10017
(212) 697-4090

PLATZER AND FALLICK
Of Counsel

2882 LUTZ APPELLATE PRINTERS, INC.
Law and Financial Printing
South River, N.J. (201) 257-6850 | New York, N.Y. (212) 840-9494 | Philadelphia, Pa. (215) 563-5587 | Washington, D.C. (202) 783-7288

TABLE OF CONTENTS

Page

Opinions Below 1

Jurisdiction 2

Questions Presented 2

Statement 2

Summary of Argument 6

Argument 8

I. Proof of scienter is a necessary element in commission actions for injunctive relief under Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and under Section 17(a) of the Securities Act of 1933. . 9

A. The analysis by this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), forces the conclusion that scienter is an essential element of a commission injunctive action under Section 10(b). 9

B. Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934 should be construed *in pari materia*. 15

Conclusion 23

Page

TABLE OF CITATIONS

Cases Cited:

Arthur Lipper Corp. v. SEC, 547 F. 2d 171 (2nd Cir. 1976) 13

Axelrod & Co. v. Kondich, Victor & Neufield, 451 F. 2d 838 (2nd Cir. 1971) 20

Ballard & Cordell Corp. v. Zoller & Danneberg, 544 F. 2d 1059 (10th Cir. 1976) 20

Erlenbaugh v. United States, 409 U.S. 239 (1972) 16, 20

Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976) 4, 5, 6, 7, 8, 9, 11, 13, 15, 16, 17, 18

Globus v. Law Research Service, Inc., 418 F. 2d 1276 (2nd Cir. 1969), cert. denied, 397 U.S. 913 (1970) ... 7, 16, 19, 22

Golub v. PPD Corp., 576 F. 2d 759 (8th Cir. 1978) 19

Malik v. Universal Resources Corp., 425 F. Supp. 350 (D. Cal. 1976) 22

Mawod & Co. v. SEC, 591 F.2d 588 (10th Cir. 1979) 6

Morton v. Mancari, 417 U.S. 535 (1972) 19

Randzanower v. Touche Ross & Co., 426 U.S. 148 (1976) 19

Sanders v. John Nuveen & Co., 554 F. 2d 790 (7th Cir. 1977) 17

Page

Sante Fe Industries, Inc. v. Green, 430 U.S. 462 (1977) 14

SEC v. Arthur Young & Co., No. 77-1768 (9th Cir. 1979) 6

SEC v. Bausch & Lomb, Inc., 420 F. Supp. 1226 (S.D.N.Y.) aff'd on other grounds, 565 F. 2d 8 (2d Cir. 1977) 6

SEC v. Blatt, 583 F. 2d 1325 (5th Cir. 1978) 5, 6, 7, 11, 12

SEC v. Capital Gains Research Bureau, 375 U.S. 180 (1963) 13, 14, 15

SEC v. Cenco, Inc., 436 F. Supp. 193 (N.D. Ill. 1977) 6

SEC v. Coven, 581 F. 2d 1020 (2nd Cir. 1978), cert. denied, ___ U.S. ___ (1979) 6, 17, 18

SEC v. Geotek, 426 F. Supp. 715 (N.D. Cal. 1976) 6

SEC v. Texas Gulf Sulphur Co., 401 F. 2d 833 (2nd Cir. 1968), cert. denied, 394 U.S. 976 (1969) 12

SEC v. Willis, ___ F. Supp. ___ (D.D.C. 12/14/78) 6, 11

SEC v. World Radio Mission, Inc., 544 F. 2d 535 (1st Cir. 1976) 6

Steadman v. SEC, ___ F. 2d ___ (5th Cir. 10/4/79) 6, 16, 18

Tchereprin v. Knight, 389 U.S. 332 (1967) 21

Touche Ross & Co. v. Redington, ___ U.S. ___ (1979), 61 L. Ed. 2d 82 (1979) 7, 10, 12

Page

Transamerica Mortgage Advisors, Inc. v. Lewis, ___ U.S. ___ (Nov. 13, 1979) 10

Trussell v. United Underwriters, Ltd., 288 F. Supp. 757 (D. Colo. 1964) 17

Vacca v. Intra Management Corp., 415 F. Supp. 248 (E.D. Penn) 22

Statutes Cited:

Section 17(a), Securities Act of 1933 ..... passim

15 U.S.C. §77e(a) 3

15 U.S.C. §77e(c) 3

15 U.S.C. §77q(a) 2, 3

15 U.S.C. §77t(b) 2, 3

Section 10(b), Securities Exchange Act of 1934 ..... passim

15 U.S.C. §78u(d)(a) 2, 3

15 U.S.C. §78(j)b 2, 3, 9

15 U.S.C. §78o(b)(4)(c) 14

28 U.S.C. §1254(1) 2

Investment Advisors Act of 1970, 15 U.S.C. §80(b)-3(e) 14

Investment Company Act of 1970, 15 U.S.C. §80(a)-9(a)(2) 14

Page

Rules Cited:

Securities & Exchange Commission Rule 2(e)(3)(i), 17 C.F.R. §201.2(e)(3)(i) (1976) 14

Securities & Exchange Commission Rule 252(c)(4) 17 C.F.R. §230.252(c)(4) (1976) 14

Securities & Exchange Commission Rule 10b-5, 17 C.F.R. §240-10b-5 (1975) 2, 3, 6, 7, 8, 9, 11, 18, 19

Other Authorities Cited:

Berner & Franklin, Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder, 51 N.Y.U. L. Rev. 769 (1976) 14, 15

Douglas & Bates, The Federal Securities Act of 1933, 43 Yale L. J. 171 (1933) 19

Hearings on HR 7852 and HR 8720, House Commission on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934) 10

3 L. Loss, Securities Regulation 1441 (2d ed. 1961) ... 17, 18, 19

6 L. Loss, Securities Regulation 3552 (2d ed. Supp. 1969) 17, 18, 22

Note, The Scienter Requirement in S.E.C. Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder, 77 Colum. L. Rev. 419 (1977) 18

Southerland, Statutory Construction, §51.03 21

Webster's New Twentieth Century Dictionary Unabridged, 2d Edition 1970 18

In The

Supreme Court of the United States

October Term, 1979

No. 79-66

PETER E. AARON,

Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (A1-A29)* is not yet officially reported. The opinion of the district court (A30-A50) is not officially reported.

* Parenthetical references "A " refer to pages of the appendix to the printed petition for a writ of certiorari; " a" refer to appendix accompanying this brief for petitioner.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1979. On June 11, 1979, Mr. Justice Marshall extended the time within which to file a petition for a writ of certiorari to and including July 10, 1979. The petition for a writ of certiorari was filed on that date and was granted on October 15, 1979. The jurisdiction of this Court rests upon 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

1. Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of Section 10(b) of the Securities and Exchange Act of 1934, 15 U.S.C. §78j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. §240.10b-5 (1975).

2. Whether the Securities and Exchange Commission is required to establish scienter as an element of a government enforcement action to enjoin violations of Section 17(a) of the Securities Act of 1933, 15 U.S.C. §77q(a).

STATEMENT

This appeal presents questions with respect to whether scienter is a necessary element in injunctive actions brought by the Securities and Exchange Commission (hereinafter referred to as "Commission") to enforce violations of Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 thereunder, and Section 17(a) of the Securities Act of 1933.[1]

---

1. The Securities and Exchange Commission is authorized by §21(d) of the 1934 Act to bring injunctive actions to enforce the statute and rules promulgated thereunder, 15 U.S.C. §78u(d)(a) (1975). Likewise, the Commission is authorized by §20(b) of the 1933 Act to bring injunctive actions to enforce the statute, 15 U.S.C. §77t(b) (1976).

The Securities and Exchange Commission brought this action for preliminary and final injunctive relief pursuant to Section 20(b) of the 1933 Act, 15 U.S.C. §77t(b) (1976), and Section 21(d) of the 1934 Act, 15 U.S.C. §78u(d)(a)(1976). The complaint filed on February 26, 1976 charged Aaron and three other defendants with violating and aiding and abetting violations of the registration provisions of §§5(a) and 5(c) of the 1933 Act, 15 U.S.C. §§77e(a) and 77(e)(c) (1976) (13a-15a). The complaint also alleged that Aaron and seven other defendants[2] violated the anti-fraud provisions of both acts, Section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) (1970), Section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) (1970), and of Rule 10b-5 promulgated thereunder, 17 C.F.R. §240.10b-5 (1971), in connection with the offer and sale of common stock of Lawn-A-Mat Chemical & Equipment Corp (15a-21a). Specifically, the complaint alleged that Aaron, who was an employee and assistant to the President of E. L. Aaron & Co., Inc., a broker-dealer registered with the Commission, exercised managerial and supervisory authority over E. L. Aaron & Co., Inc.'s registered representatives. In this connection, it was charged that petitioner, after being informed that employees of the broker-dealer firm were making false and misleading statements in connection with their attempts at selling LAM stock, did nothing to stop the false and misleading misrepresentations from being made by the employees (16a-19a). After a three day evidentiary hearing in the Southern District of New York, the district court concluded that Aaron had violated the anti-fraud provisions of the 1933 and 1934 Acts and the registration provisions of the 1933 Act (A37-A45).

In addition, the district court found that "while Aaron himself did not make any misrepresentations, by failing to stop Schreiber and Jacobson, he willfully aided and abetted their violations of the anti-fraud provisions of the securities laws" (A39-A40). Moreover, the district court also determined that:

---

2. The seven other defendants other than Aaron consented to the entry of permanent injunction against them.

> "While negligence alone may suffice as a standard for liability in Commission enforcement proceedings, the fact that Peter Aaron intentionally failed to terminate the false and misleading statements made by Schreiber and Jacobson, knowing them to be fraudulent, is sufficient to establish his scienter under the securities laws." (Citations omitted.) (A40).

Accordingly, the court permanently enjoined Aaron from further such violations (A44-A45).

The judgment rendered by the district court was affirmed by the court of appeals. It held, in short, that in the context of an enforcement action brought by the Commission to enjoin violations of either §10(b) or §17(a), proof of scienter, on the part of the defendant is not required.

In reliance upon its "carefully reasoned pre-*Hochfelder*[3] decisions", the language and history of Section 10b, and the compelling distinction between private damage actions and government injunction actions, the court of appeals held that "the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under 10(b) of the 1934 Act and §17(a) of the 1933 Act" (A13-A19).[4]

---

3. In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that proof of scienter is a necessary element in a private damage action under §10(b). This Court also stated:

> "Since this case concerns an action for damages, we also need not consider the questions whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5. *Cf. SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 11 L at 2d 237, 84 S. Ct. 275 (1963)." 425 U.S. at 194 n. 12.

4. The court of appeals also stated,

(Cont'd)

In so holding, the court of appeals conceded that its interpretation of §10(b) conflicts with that adopted by the Fifth Circuit in *SEC v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978). The court found that "the language of Section 10(b) alone is not determinative of the issue and that resort to legislative history and purpose is proper" (A16).[5] In discussing the legislative history, the court of appeals examined §21(d) of the 1934 Act, the explicit statutory provision which authorizes the Commission to bring an injunctive action. It found that Congress expressly indicated at the time of the enactment of §21(d) that Commission injunctive actions are exempt from the scienter requirement application to private action (A17-A18).

In addition, the court of appeals held that policy considerations underlying the Securities Acts clearly reflect that a negligence standard should be applied in a government enforcement action (A18-A19). These holdings completely conflict with *Blatt*. There, the Fifth Circuit held that the language and history of §10(b) as analyzed and discussed in *Hochfelder*, conclusively demonstrates that scienter is a necessary element in a government enforcement action. 583 F. 2d 1332. The Fifth Circuit further stated that the language of §10(b) is sufficiently clear in its context, and thus controlling, notwithstanding considerations of public policy. 583 F. 2d 1332.

(Cont'd)

> "We find it unnecessary to reach the question whether Aaron's conduct would support a finding of scienter, since we hold that the scienter requirement enunciated in *Hochfelder* is not applicable to government enforcement actions brought under §§10(b) and 21(d) of the 1934 Act." (A13-A14).

5. In *Hochfelder*, at 214, n. 33, this Court stated,

> "As we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of 'policy', set forth by the parties, that may have influenced the lawmakers in their formulation of the statute."

Thus, the conflict between the decision below and *Blatt* is complete.[6]

Moreover, the court of appeals, relying on its discussion of §10(b) and its previous analysis in *SEC v. Coven*, 581 F. 2d 1020, 1026-1028 (2d Cir. 1978), held that scienter is not required in a Commission injunctive action under §17(a) (A19-A20).[7]

SUMMARY OF ARGUMENT

The issue before this Court is whether the Securities and Exchange Commission must allege and prove scienter in actions for injunctive relief for violations of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated thereunder.

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), this Court held that proof of scienter is a necessary element in a private damage action under Section 10(b). This Court, in *Hochfelder*, based its conclusion primarily on the statutory text

---

6. The Tenth Circuit has apparently followed the Fifth Circuit in finding that scienter is a necessary element of a government enforcement action. *Edward J. Mawod & Co. v. SEC*, 591 F. 2d 588, 595 (10th Cir. 1979). *See also, SEC v. Willis*, ___ F. Supp. ___ (D.D.C. 12/14/78). Scienter is an essential element of a SEC injunctive action under Section 10(b). *SEC v. Cenco, Inc.*, 436 F. Supp. 193, 200 (N.D. Ill. 1977); *SEC v. Bausch & Lomb, Inc.*, 420 F. Supp. 1226, 1241 (S.D.N.Y.), *aff'd on different grounds*, 565 F. 2d 8 (2d Cir. 1977).

The First and Ninth Circuits, however, have held that negligence is the appropriate standard in a government enforcement action. *SEC v. World Radio Mission*, 544 F. 2d 535, 541 n. 10 (1st Cir. 1976); *SEC v. Arthur Young & Co.*, No. 77-1768 at 3 (9th Cir. 1979); *see also, SEC v. Geotek*, 426 F. Supp. 715, 726 (N.D. Cal. 1976).

7. Subsequent to the court of appeals decision, the Fifth Circuit Court of Appeals in *Steadman v. Securities and Exchange Commission*, ___ F. 2d ___ (5th Cir. Oct. 4, 1979), held that scienter is an element of a violation of subsection 17(a)(1).

of Section 10(b), the legislative history, its setting within the statutory scheme of the 1933 and 1934 Acts, and the administrative history of Rule 10b-5. Since private damage actions and enforcement proceedings both must rely upon the same language and history of Section 10(b), identical elements of proof are required for the two types of actions. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 217-218 (1976) (Blackmun, J., dissenting); *Securities and Exchange Commission v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978). In addition, the policy considerations present in Commission injunctive actions do not justify applying a different standard from that required in private damage actions. *Ernst & Ernst v. Hochfelder*, 425 U.S. 214, n. 33, *see also, Touche Ross & Co. v. Redington*, ___ U.S. ___ (1979), 61 L. Ed. 2d 82, 97 (1979); *SEC v. Blatt, supra* at 1333.

Furthermore, proof of scienter should also be made a requirement in Commission injunctive actions brought under Section 17(a). The "courts have endeavored to treat the 1933 and 1934 Acts *in pari materia* and to construe them as a single comprehensive scheme of regulation." *Globus v. Law Research Service, Inc.*, 418 F. 2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). It is unlikely that Congress (the same Congress that passed the Securities Act of 1933, also approved the Securities Exchange Act of 1934) intended to have different elements of proof for injunctive actions brought under Section 10(b) or Section 17(a). Both sections deal with the same subject matter, viz., anti-fraud measures relating to the offer and sale, and purchase of securities.

ARGUMENT

In *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194, n.12 (1976), this Court held that proof of scienter[8] is a necessary element in a private damage action under Section 10(b) of the Securities and Exchange Act of 1934, and Rule 10b-5. This Court also stated:

> "since this case concerns an action for damages, we also need not consider the question whether scienter is a necessary element in an action for injunctive relief under §10(b) and Rule 10b-5. *Cf. SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 11 L. Ed. 2d 237, 84 S. Ct. 275 (1963)."

Mr. Justice Blackmun in dissent, with whom Mr. Justice Brennan joined, stated, ". . . for surely the question whether negligent conduct violates the Rule should not depend upon the plaintiff's identity. If negligence is a violation factor when the SEC sues, it must be a violation factor when a private party sues." (425 U.S. at 217-218).

The issue before this Court, therefore, is whether the reasoning on which the *Hochfelder* decision is based requires the conclusion that the Commission must allege and prove scienter in actions for injunctive relief for violations of the anti-fraud provisions of the 1933 and 1934 Acts.

---

8. In *Hochfelder*, 420 U.S. at 194, n. 12, this Court defined scienter as "a mental state embracing intent to deceive, manipulate, or defraud." Since, however, the court of appeals did not address themselves to whether Aaron's conduct would support a finding of scienter, the question of what constitutes scienter is not before this Court.

I.

PROOF OF SCIENTER IS A NECESSARY ELEMENT IN COMMISSION ACTIONS FOR INJUNCTIVE RELIEF UNDER SECTION 10(b) OF THE SECURITIES AND EXCHANGE ACT OF 1934 AND RULE 10b-5 PROMULGATED THEREUNDER, AND UNDER SECTION 17(a) OF THE SECURITIES ACT OF 1933.

A. The analysis by this Court in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), forces the conclusion that scienter is an essential element of a commission injunctive action under Section 10(b).

This Court in *Hochfelder* based its conclusion primarily on the statutory text of Section 10(b), the legislative history, its setting within the statutory scheme of the 1933 and 1934 Acts, and the administrative history of Rule 10b-5. Construing the language of Section 10(b),[9] this Court determined that the "words manipulative or deceptive" used in conjunction with device or contrivance strongly suggest that §10(b) was intended to proscribe knowing or intentional misconduct (425 U.S. at

---

9. Section 10 of the Securities Exchange Act of 1934, 15 U.S.C. §78j provides in relevant part:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means for instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

197).[10] Moreover, this Court stressed as "especially significant" the use of the word "manipulation." "It is and was virtually a term of art when used in connection with securities markets. It connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." (425 U.S. at 199).

In examining the legislative history of Section 10(b), this Court found relevant portions of the legislative history to "support (its) conclusion that §10(b) was addressed to practices that involve some element of scienter and cannot be read to impose liability for negligent conduct alone." (425 U.S. at 201-206).[11]

---

10. "*Ernst & Ernst v. Hochfelder*, at 197, makes clear the starting point in every case involving construction of a statute is the language itself." *Transamerica Mortgage Advisors, Inc., et al. v. Lewis*, ___ U.S. ___ (Nov. 13, 1979), 48 LW 4001, *Touche Ross & Co. v. Redington*, ___ U.S. ___ (1979), 61 L. Ed. 2d 82, 91.

11. This Court quoted at 425 U.S. at 202 what it regarded as the "most relevant exposition of the provision that was to become §10(b)."

Subsection (c) [§9(c) of HR 7852 — later §10(b)] says, "Thou shalt not devise any other cunning devices."

> "Of course subsection (c) is a catch-all clause to prevent manipulative devices. I do not think there is any objection to that kind of clause. The Commission should have the authority to deal with new manipulative devices" Hearings on HR 7852 and HR 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934).

> "This brief explanation of §10(b) by a spokesman for its drafters is significant. The section was described rightly as a 'catchall' clause to enable the Commission 'to deal with new manipulative (or cunning) devices.' It is difficult to believe that any lawyer, legislative draftsman, or legislator would use these words if the intent was to create liability for merely negligent acts or omissions."

Furthermore, this Court also noted that the administrative history of Rule 10b-5 "(makes) clear that when the Commission adopted the Rule, it was intended to apply only to activities that involved scienter" 425 U.S. at 212. Finally, this Court held that "its scope (Rule 10b-5) cannot exceed the power granted the Commission by Congress under §10(b), 425 U.S. at 214. Analysis of the statute had already revealed that Congress intended to proscribe only intentional misconduct.

Accordingly, this Court's interpretation of the language and history of Section 10(b) compels a requirement of scienter in Commission enforcement proceedings as well. Since private damage actions and enforcement proceedings both must rely upon the same language and history of Section 10(b), this Court's construction in *Hochfelder* warrants an identical standard for the two types of actions. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 217-218 (1976) (Blackmun, J., dissenting). In *Securities and Exchange Commission v. Blatt*, 583 F. 2d 1325, 1333 (5th Cir. 1978), the court of appeals stated:

> "*Hochfelder's* analysis applies forcefully to the issue sub judice. If the language and history of §10(b) are dispositive in private damage actions, the same must also be true in SEC injunctive actions. Both types of actions are creatures of the same statute, the language and legislative history are, of course, the same."

Accord SEC v. Willis, ___ F. Supp. ___ (D.D.C. Dec. 14, 1978).

In addition, in *Blatt*, the court of appeals also found that the legislative history relied upon by this Court in *Hochfelder* applies with even greater force to Commission enforcement actions. The court of appeals stated at 583 F. 2d 1333, n. 21:

> "Perhaps the language and history of §10(b) permit a stronger inference that Congress

> intended to require scienter in SEC actions than in private damage suits. The Supreme Court has determined that Congress did not contemplate private actions under §10(b). *Hochfelder*, 425 U.S. at 196, 96 S. Ct. 1375. Therefore, it follows logically that the scienter requirement implicit in the statute must have been intended for SEC proceedings. *See Note, Scienter and Injunctive Relief Under Rule 10b-5, 11 Ga. L. Rev. 879, 891 (1977).*"

Although the Second Circuit Court of Appeals strongly urged that policy considerations present in Commission injunctive actions provide a sufficient means to distinguish private actions for damages, this Court noted "as we find the language and history of §10(b) dispositive of the appropriate standard of liability, there is no occasion to examine the additional considerations of "policy" set forth by the parties, that may have influenced the lawmakers in their formulation of the statute." 425 U.S. 214, n. 33. *See also, Touche Ross & Co. v. Redington,* ___ U.S. ___ (1979), 61 L. Ed. 2d 82, 97 (1979) ("Only last term, we emphasized that generalized references to the remedial purposes of the 1934 Act will not justify reading a provision more broadly than its language and the statutory scheme reasonably permit."); *Securities and Exchange Commission v. Blatt,* 583 F. 2d 1325, 1333 (5th Cir. 1978) ("Despite the appeal of such policy arguments, the language of the statute must control when sufficiently clear in its context. In our judgment, the language of §10(b) controls.")[12]

---

12. The policy arguments relied upon by the Second Circuit Court of Appeals, are perhaps best summarized in a quote from *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 854-855 (2d Cir. 1968) (en banc), *cert. denied*, 394 U.S. 976 (1969):

> "In an enforcement proceeding for equitable or prophylactic relief, the common law standard of deceptive conduct has been modified in the interests of broader protection for the

(Cont'd)

(Cont'd)

> investing public . . . for policy reasons which seem perfectly consistent with the broad Congressional design.
>
> Absent any clear indication of a legislative intention to require a showing of specific fraudulent intent . . . the securities laws should be interpreted as an expansion of the common law both to effectuate the broad remedial design of Congress . . . and to insure uniformity of enforcement. . . . Moreover . . . the implementation of a standard of conduct that encompasses negligence comports with the administrative and the legislative purposes underlying the Rule. . . . This requirement, whether it be termed lack of diligence, constructive fraud, or unreasonable or negligent conduct, remains implicit in this standard, a standard that promotes the deterrence objective of the Rule." (Footnotes and citations omitted.)

This "effect analysis" approach was rejected by this Court in *Hochfelder*, 425 U.S. 198-199:

> "(T)he commission cites the overall congressional purpose in the 1933 and 1934 Acts to protect investors against false and deceptive practices that might injure them. . . . The Commission then reasons that since the 'effect' upon investors of given conduct is the same regardless of whether the conduct is negligent or intentional, Congress must have intended to bar all such practices and not just those done knowingly or intentionally. The logic of this effect-oriented approach would impose liability for wholly faultless conduct where such conduct results in harm to investors, a result the Commission would be unlikely to support. But apart from where its logic might lead, the Commission would add a gloss to the operative language of the statute quite different from its commonly accepted meaning."

Moreover, the argument that an injunction does not impose the serious burdens imposed by money judgments (*see e.g., SEC v. Capital Gains Research Bureau,* 375 U.S. 180, 193 (1963); *Arthur Lipper Corp. v. SEC*, 547 F. 2d 171, 180, n. 6 (2d Cir. 1976) is also inapplicable.

(Cont'd)

Further, any reliance on *SEC v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963) is misplaced. The issue in *Capital Gains* was "whether under the Investment Advisers Act of 1940 the Securities and Exchange Commission may obtain an injunction compelling a registered investment adviser to disclose to his clients a practice of purchasing shares of a security for his own account shortly before recommending that security for long-term investment and then immediately selling the shares at a profit upon the rise in the market price following the recommendation." The action was brought alleging violations of Section 206(2) of the Investment Advisers Act of 1940, which prohibits any practice which operates as a "fraud or deceit" upon any client.

In *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462 (1977) n. 11, this Court noted that "although *Capital Gains* involved a federal securities statute, the court's references to fraud in the

(Cont'd)

For example, an injunction can result in the suspension or revocation of a broker-dealer's registration, or can constitute grounds for barring any person from associating with a broker-dealer, under §15(b)4(c) of the 1934 Act, 15 U.S.C. §78o(b)(4)(c) (1970). Similar penalties can arise for investment advisers under §203(e) of the Investment Advisers Act, 15 U.S.C. §80(b)-3(e) (1970). In like manner, §9(a)(a) of the Investment Company Act, 15 U.S.C. §80(a)-9(a)(2) (1970), prohibits anyone subject to an injunction from serving as an employee, officer, director, member of an advisory board, investment adviser or depositor of a registered investment company. The granting of an injunction can also constitute grounds for barring any attorney, accountant or other expert from practicing before the SEC, under SEC Rule 2(e)(3)(i), 17 C.F.R. §201.2(e)(3)(i) (1976). Finally, an issuer of securities subject to injunction may be deprived of a Regulation A exemption under Rule 252(c)(4) of Regulation A, 17 C.F.R. §230.252(c)(4) (1976).

In addition, the consequences of an injunction, such as loss of business, injury to reputation, and potential disbarment from practice before the Commission, make the injunction as significant to the professional as the imposition of money damages would be to anyone else. *Accord*, Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: A Reappraisal in Light of Hochfelder*, 51 N.Y.U. L. Rev. 769, 787-788 (1976).

'equitable' sense of the term were premised on its recognition that Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers."[13]

Thus, the statutory text and legislative history of Section 206 of the Investment Advisers Act are dissimilar to that of Section 10(b) of the 1934 Act, and are of no significance in determining the elements for a government enforcement action under Section 10(b).[14]

In sum, the analysis by this Court in *Hochfelder* warrants that identical standards be applied in both damage actions and enforcement actions.

B. Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities and Exchange Act of 1934 should be construed *in pari materia*.

The court of appeals also found that Aaron violated Section 17(a) of the Securities Act,[15] concluding that scienter is not an

13. In *Capital Gains*, 376 U.S. 190, n. 39, however, Mr. Justice Goldberg specifically found that the defendant's failure to disclose was purposeful, and that they intended that action be taken in reliance on the claimed disinterestedness in the securities transactions they recommended.

14. For an extensive criticism of *Capital Gains*, *see Berner & Franklin, supra*, at 781-787.

15. Section 17(a) of the Securities Act provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly
>
> (1) to employ any device, scheme, or artifice to defraud, or

(Cont'd)

element in a Commission injunctive action under that section. The statutory language of Section 17(a)(2) and possibly that of Section 17(a)(3) indicates that those subsections were intended to proscribe conduct not involving scienter. Moreover, the legislative history of Section 17(a) apparently implies that scienter was not intended as an element of that section. Petitioner contends, however, that this Court's holding in *Hochfelder* requires a finding of scienter for government enforcement actions under Section 10(b) and, therefore, under "settled principles of statutory construction", the same standards should apply to injunctive actions brought by the Commission under Section 17(a). *See Erlenbaugh v. United States,* 409 U.S. 239, 243 (1972); the two Acts are *in pari materia* and should be construed together as one body of law. *Globus v. Law Research Service, Inc.,* 418 F. 2d 1276, 1286 (2d Cir. 1969), *cert. denied,* 397 U.S. 913 (1970). Prior to discussing the principle of *in pari materia* in this context, petitioner will review the statutory language and legislative history of Section 17(a).

The language of Section 17(a)(1) clearly requires some showing of scienter. In *Steadman v. SEC,* ____ F. 2d ____ (5th Cir. October 4, 1979), the Fifth Circuit Court of Appeals addressed themselves to the meaning of Section 17(a)(1):

> "We come now to subsection 17(a)(1). This clause contains the word 'device' that the Supreme

---

(Cont'd)

> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

> Court in *Hochfelder* found to be suggestive of intentional conduct when read together with 'manipulative' and 'deceptive'. 425 U.S. at 197, 96 S. Ct. at 1383. The latter two words do not appear in subsection 17(a)(1), but the three words of that section — device, scheme, and artifice — must each be read in conjunction with the words 'to defraud'. *The resulting phrases — device to defraud, scheme to defraud, artifice to defraud — carry strong implications of intentional conduct. We do not think Congress would have used such language if it meant to reach merely negligent actions.* The use of the term 'employ' further supports our reading of the section. See *Hochfelder,* 425 U.S. at 199, n. 20, 96 S. Ct. at 1384." (Emphasis added.)

See also, Sanders v. John Nuveen & Co., 554 F. 2d 790, 795 (7th Cir. 1977); *Trussell v. United Underwriters, Ltd.,* 288 F. Supp. 757, 770 (D. Colo. 1964); 3 L. Loss, *Securities Regulation,* 1441-1442 (2d Ed. 1961).

Subsection (2) of 17(a), however, makes no reference to fraud, deceit or schemes. This language, arguably, does not require scienter. The Second Circuit Court of Appeals in *SEC v. Coven,* 581 F.2d 1020, 1026 (1978), *cert. denied,* ____ U.S. ____ (1979), and the Fifth Circuit Court of Appeals in *Steadman v. SEC, supra,* have concluded that scienter is not required in a Commission injunctive action under subsection (2). Professor Loss has also stated: "There is nothing on the face of clause (2) itself that smacks of scienter or intent to defraud at all."[16] 6 L. Loss, *Securities Regulation,* 3552-3553 (2d Ed. Supp. 1969).

---

16. Indeed this Court in *Hochfelder,* 425 U.S. at 212 stated:

> "Viewed in isolation the language of subsection (b), and arguably that of subsection (c), could be read as proscribing, respectively, any type of material misstatement or omission,

(Cont'd)

Moreover, prior analyses of Section 17(a)(3) have resulted in conflicting interpretations. This Court in *Hochfelder*, 425 U.S. at 212, acknowledged that the language of Rule 10b-5(c) "could be read as proscribing, . . . any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not." The Second Circuit Court of Appeals, in *SEC v. Coven, supra*, and the Fifth Circuit Court of Appeals in *Steadman v. SEC*, *supra*, both have concluded that "the clear impact of the critical phrase in subsection (3), 'operates as a fraud', is to focus attention on the effect of potentially misleading conduct on the public, not on the culpability of the person responsible." 581 F. 2d at 1026. Conversely, Professor Loss has argued that the use of the terms fraud and deceit in subsection (3) suggests that a scienter standard is contained in subsection (3),[17] 3 L. Loss, *Securities Regulation*, 1441-1442 (2d Ed. 1961); 6 L. Loss, *Securities Regulation*, 3552 (2d Ed. Supp. 1969).

In addition, analysis of the legislative history of §17 apparently indicates that Congress did not intend that scienter should be an element of a government enforcement action under Section 17(a). That history has been canvassed in *SEC v. Coven*, 581 F. 2d at 1027; *see also*, Note, *The Scienter Requirement in S.E.C. Injunctive Enforcement of Section 10(b) After Ernst & Ernst v. Hochfelder*, 77 Colum. L. Rev. 419, 429-432 (1977);

(Cont'd)
and any course of conduct, that has the effect of defrauding investors, whether the wrongdoing was intentional or not."

Subsections (b) and (c) of Rule 10b-5 are almost identical with subsections (2) and (3) of Section 17(a) respectively.

17. *Webster New Twentieth Century Dictionary Unabridged*, Second Edition, 1970, defines fraud as:

"(a) deceit, trickery, cheating;

(b) in law, intentional deception to cause a person to give up property or some lawful right."

Douglas & Bates, *The Federal Securities Act of 1933*, 43 Yale L. J. 171, 181-182 (1933) ("Section 17 makes unlawful all schemes to defraud. Likewise it makes unlawful all schemes to defraud. Likewise it makes unlawful even innocent acts to obtain money or property, by means of untrue statements of material facts or omissions to state material facts").

Petitioner contends, however, that the three subsections of 17(a) should be construed together with Section 10(b) to require proof of scienter in government enforcement actions. It is a well-settled principle of statutory construction that statutes should be reconciled where possible. *Radzanower v. Touche Ross & Co.*, 426 U.S. 148, 155 (1976), quoting *Morton v. Mancari*, 417 U.S. 535, 550 (1972). Section 10(b) and Rule 10b-5 promulgated thereunder, and Section 17(a) of the Securities Act of 1933 are general anti-fraud provisions obviously aimed at the same general evils in the field of securities regulation. Section 17(a) refers to fraud or misrepresentation "in the offer or sale of any securities". Section 10(b) and Rule 10b-5 applies to fraud in the *purchase* or sale of any security. In fact "Rule 10b-5 merely borrows the language of §17(a) of the Securities Act, except for the reference in clause (2) to obtaining any money or property by means of an untrue statement or half-truth". 3 L. Loss, *supra* at 1426-1427 (2d Ed. 1961).

Thus, if scienter is to be required in Commission actions for injunctive relief under Section 10(b) and Rule 10b-5, it should also be required in Commission actions for injunctive relief pursuant to Section 17(a). It must be remembered that the very purpose of adopting Rule 10b-5 was to eliminate the differences in treatment of buyer and seller transactions. To permit any distinction between the Acts would create an anomaly. Therefore, to avoid such inconsistencies, these Acts have been treated *in pari materia* and construed as a single comprehensive scheme of regulation. *Globus v. Law Research Service, Inc.*, 418 F. 2d 1276, 1286 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). *See also, Golub v. PPD Corp.*, 576 F. 2d 759, 764 (8th

Cir. 1978); *Ballard & Cordell Corp. v. Zoller & Danneberg*, 544 F. 2d 1059, 1066 (10th Cir. 1976); *Axelrod & Co. v. Kondich, Victor & Neufield*, 451 F. 2d 838, 843 (2d Cir. 1971).

In *Erlenbaugh v. United States*, 409 U.S. 239, 243-244 (1972), this Court construed the rule of *in pari materia* by stating:

> "*The rule of in pari materia* like any canon of statutory construction is a reflection of practical experience in the interpretation of statutes: a legislative body generally uses a particular word with a consistent meaning in a given context. Thus, for example, a 'later act can . . . be regarded as a legislative interpretation of (an) earlier act . . . in the sense that it aids in ascertaining the meaning of the words as used in their contemporary setting,' and 'is therefore entitled to great weight in resolving any ambiguities and doubts'. *United States v. Stewart, supra*, at 64-65. See also, e.g., *Hunter v. Erickson*, 393 U.S. 385, 388 (1969); *United States v. Freeman, supra*, at 565. The rule is but a logical extension of the principle that individual sections of a single statute should be construed together, for it necessarily assumes that whenever Congress passes a new statute, it acts aware of all previous statutes on the same subject, cf. *Allen v. Grand Central Aircraft Co.*, 347 U.S. 535, 541-552 (1954). Given this underlying assumption, the rule's application certainly makes the most sense when the statutes were enacted by the same legislative body at the same time."[18]

18. "To be *in pari materia*, statutes need not have been enacted simultaneously or refer to one another. However, application of the rule that statutes *in pari materia* should be construed together is most justified, and light from that source has the greatest probative force, in the case of statutes

(Cont'd)

That Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act are *in pari materia* is manifest. Both deal with the same subject matter, viz., anti-fraud measures relating to the offer and sale, and purchase of securities. Moreover, the same Congress which passed the Securities Act in 1933 approved the Securities Exchange Act in 1934, *Tchereprin v. Knight*, 389 U.S. 332, 342 (1967). In addition, Professor Loss has stated:

> "There is abundant evidence, even apart from the 1934 amendments of the 1933 act, *that the two statutes are in pari materia — indeed, as closely related as two nominally separate statutes could be:*
>
> (1) President Roosevelt, in his message recommending a Securities Act, stated, as he specifically recalled in his message of the next year recommending an act to regulate the stock exchanges:
>
> This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all

(Cont'd)

relating to the same subject matter that were passed at the same session of the legislature, especially if they were passed or approved or take effect on the same day, or in the case where the later of two or more statutes relating to the same subject matter refers to the earlier. In these situations the probability that acts relating to the same subject matter were actuated by the same policy is very high, for in the first three situations mentioned they were enacted by the same men and in the last were declared to be within the knowledge of the legislature at the same time. But in construing an ambiguous enactment it is held proper to consider not only acts passed at the same session of the legislature or other acts to which the act in question refers, but also acts passed at prior and subsequent sessions to which the act does not refer. However, if a subsequent action is in irreconcilable conflict with the act under consideration, the subsequent act must prevail." *Sutherland, Statutory Construction*, §51.03.

> property dealt in on exchanges . . ." (Citations omitted, emphasis added.) 6 L. Loss, *Securities Regulation*, 3915-3916 (2d Ed. Supp. 1969)

Accordingly, to eliminate any anomaly between the elements for an injunctive action under Section 17(a) and Section 10(b), proof of scienter should be made a requirement in actions brought under either section. The "courts have endeavored to treat the 33 and 34 Acts *in pari materia* and to construe them as a single comprehensive scheme of regulation." *Vacca v. Intra Management Corp.*, 415 F. Supp. 248, 250 (E.D. Penn.) quoting, *Globus v. Law Research Service, Inc., supra.* In *Vacca*, that district court held that "While the Supreme Court left open the question of whether scienter is a necessary element in an action for injunctive relief under those provisions, 96 S. Ct. at 1381 n. 12, we believe that the *Ernst & Ernst v. Hochfelder* holding applies equally to both equitable actions for rescission and actions at law for money damages." (Citations omitted.) *See also, Malik v. Universal Resources Corp.*, 425 F. Supp. 350 (D. Cal. 1976) (Scienter is a required element of proof under §17(a) in a private damage action).

In sum, Section 17(a) of the 1933 Act should be read in harmony with Section 10(b) of the 1934 Act to require a showing of scienter before an injunction will issue.

CONCLUSION

The judgment of the court of appeals should be reversed, and the case be remanded for further proceedings to decide whether Aaron's conduct would support a finding of scienter.

Respectfully submitted,

Barry M. Fallick
Kenneth J. Platzer
Attorneys for Petitioner